CEPS COMMENTARY
Thinking ahead for Europe

What's wrong with Europe's banks?

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12 July 2013

The short answer to this question is that the sector is undercapitalised, too large and contains too many players without a viable long-term business model. It is the combination of the last two factors that constitutes the most serious and most difficult problem.

The size of the banking sector is a cause for concern because, with total liabilities over 250% of GDP (for the eurozone), it is clear that the emergence of any major problem could over-burden public budgets. In short, the banking sector in Europe might be 'too big to be saved'.

The problem of undercapitalisation can be cured by an infusion of new capital. But the larger the banking sector, the more difficult this becomes. Moreover, it simply does not make sense to put new capital into banks that cannot return profits any time in the foreseeable future

The difficulties in southern Europe are well known, but they differ fundamentally from one country to another. In Spain banks have over the years issued hundreds of billions of euros worth of 30-year mortgages, whose interest rates are indexed to interbank rates (Euribor), with a small spread (often less than 100 basis points) fixed for the lifetime of the mortgage. This was a profitable model at a time when Spanish banks were able to refinance themselves at a spread much lower than 100 basis points. But today Spanish banks, especially those most heavily engaged in domestic mortgage lending, have to pay much more than 100 basis points spread over inter-bank rates on their own cost of funding. Many local Spanish banks can thus stay afloat only because they refinance a large share of their mortgage book via the European Central Bank. But reliance on cheap central bank (re)financing does not represent a viable business model.

In Italy the difficulties arise from the fact that the banks have over the years continued to lend to domestic enterprises, especially small and medium-sized enterprises (SMEs), while GDP has not grown. The productivity of capital investment in Italy was thus close to zero even before the crisis. The onset of the present recession has exposed this low productivity, as many SMEs are failing, leading to

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large losses for the banks. But funding costs have increased. It is thus difficult to see how Italian banks can return to profitability (and the country can resume growth) unless the allocation of capital is radically changed.

But there even are problems north of the Alps. In Germany banks have deposited hundreds of billions of euros in excess liquidity at the ECB on which they earn close to nothing. But their funding costs are not zero. German banks might be able to issue securities at very low rates, but even these rates are higher than what they earn on their deposits at the ECB. Moreover, they have to factor in the cost of maintaining an extensive and thus expensive domestic retail network through which they collect the savings deposits, which they now have difficulties remunerating.

There will of course always be some banks that do better and others that suffer from these negative trends. Thus one cannot avoid the task of analysing the situation of each bank separately. But it is clear that in an environment of low growth, low interest rates but high risk premia, many banks struggle to merely survive.

Unfortunately, the problem cannot be left to the markets to resolve. A bank without a viable business model does not shrink gradually and then disappear. Its share price might decline towards zero, but its retail customers will be blissfully unaware of the difficulties, and other creditors will also continue to provide financing because they expect that in the end the (national) authorities will intervene before the bank fails by either providing emergency funding or by arranging a merger with another institution. The recent official tough talk about the need to 'bail in' bank creditors has not impressed markets much, not least because the new rules on potentially inflicting losses on creditors of failing banks are supposed to enter into force only by 2018.

Starting next year, the ECB will undertake a review of the quality of the assets of the banks under its supervision, but it will not be able review the longer-term viability of business models. The present owners will resist to the end any dilution of their control; and no national authority is likely to acknowledge that their national 'champion' lacks a plausible path to financial viability.

Keeping a weak banking system afloat has high economic costs. Banks with too little capital, or those without a viable business model, tend to keep extending credit to their existing customers even if these loans are of dubious value, and they also tend to restrict lending to new companies or projects. This misallocation of capital hampers any recovery and reduces longer-term growth prospects.

What should be done is clear: recapitalise much of the sector and restructure those parts lacking a viable business model. But as this is unlikely to happen any time soon, it also unlikely that Europe can recover fully from its present slump.